

section 1374 tax are subject to the limitations described in section 38(c) and section 53(c), respectively, as modified by this paragraph. The tentative tax determined under paragraph (a)(3) of § 1.1374-1 is treated as the regular tax liability described in sections 38(c)(1) and 53(c)(1), and as the net income tax and net regular tax liability described in section 38(c)(1). The tentative minimum tax described in section 55(b) is determined using the rate of tax applicable to corporations and without regard to any alternative minimum tax foreign tax credit described in that section and by treating the net recognized built-in gain determined under § 1.1374-2, modified to take into account the adjustments of sections 56 and 58 applicable to corporations and the preferences of section 57, as the alternative minimum taxable income described in section 55(b)(2).

(c) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. Business credit carryforward. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X has a \$500,000 business credit carryforward from a C year and Asset #1 with a fair market value of \$400,000, a basis for regular tax purposes of \$95,000, and a basis for alternative minimum tax purposes of \$150,000. In 1996, X has net recognized built-in gain of \$305,000 from selling Asset #1 for \$400,000. Thus, X's tentative tax under paragraph (a)(3) of § 1.1374-1 and regular tax liability under paragraph (b) of this section is \$106,750 $(\$400,000 - \$95,000 = \$305,000 \times .35 = \$106,750)$, assuming a 35 percent tax rate). Also, X's tentative minimum tax determined under paragraph (b) of this section is \$47,000 $[\$400,000 - \$150,000 = \$250,000 - \$15,000 (\$40,000 \text{ corporate exemption amount} - \$25,000 \text{ phase-out} = \$15,000) = \$235,000 \times .20 = \$47,000]$, assuming a 20 percent tax rate]. Thus, the business credit limitation under section 38(c) is \$59,750 $[\$106,750 - \$47,000 (\text{the greater of } \$47,000 \text{ or } \$20,438 (.25 \times \$81,750 (\$106,750 - \$25,000 = \$81,750))) = \$59,750]$. As a result, X's section 1374 tax is \$47,000 $(\$106,750 - \$59,750 = \$47,000)$ for 1996 and X has \$440,250 $(\$500,000 - \$59,750 = \$440,250)$ of business credit carryforwards for succeeding taxable years.

Example 2. Minimum tax credit. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Asset #1 has a fair market value of \$5,000,000, a basis for regular tax purposes of \$4,000,000, and a basis for alternative minimum tax purposes of \$4,750,000. Y also has a minimum tax credit of \$310,000 from 1995. Y has no other

assets, no net operating or capital loss carryforwards, and no business credit carryforwards. In 1996, Y's only transaction is the sale of Asset #1 for \$5,000,000. Therefore, Y has net recognized built-in gain in 1996 of \$1,000,000 $(\$5,000,000 - \$4,000,000 = \$1,000,000)$ and a tentative tax under paragraph (a)(3) of § 1.1374-1 of \$350,000 $(\$1,000,000 \times .35 = \$350,000)$, assuming a 35 percent tax rate). Also, Y's tentative minimum tax determined under paragraph (b) of this section is \$47,000 $[\$5,000,000 - \$4,750,000 = \$250,000 - \$15,000 (\$40,000 \text{ corporate exemption amount} - \$25,000 \text{ phase-out} = \$15,000) = \$235,000 \times .20 = \$47,000]$, assuming a 20 percent tax rate]. Thus, Y may use its minimum tax credit in the amount of \$303,000 $(\$350,000 - \$47,000 = \$303,000)$ to offset its section 1374 tentative tax. As a result, Y's section 1374 tax is \$47,000 $(\$350,000 - \$303,000 = \$47,000)$ in 1996 and Y has a minimum tax credit attributable to years for which Y was a C corporation of \$7,000 $(\$310,000 - \$303,000 = \$7,000)$.

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§ 1.1374-7 Inventory.

(a) *Valuation.* The fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business. For purposes of the preceding sentence, the buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts.

(b) *Identity of dispositions.* The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in section 472). However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to

the FIFO method) with a principal purpose of avoiding the tax imposed under section 1374, it must use its former method to identify its dispositions of inventory.

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§ 1.1374-8 Section 1374(d)(8) transactions.

(a) *In general.* If any S corporation acquires any asset in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to a C corporation's basis in the assets (or any other property) (a section 1374(d)(8) transaction), section 1374 applies to the net recognized built-in gain attributable to the assets acquired in any section 1374(d)(8) transaction.

(b) *Separate determination of tax.* For purposes of the tax imposed under section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one section 1374(d)(8) transaction from the assets the S corporation acquires in another section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation's section 1374 attributes when it became an S corporation may only be used to reduce the section 1374 tax imposed on dispositions of assets the S corporation held at that time. Similarly, an S corporation's section 1374 attributes acquired in a section 1374(d)(8) transaction may only be used to reduce a section 1374 tax imposed on dispositions of assets the S corporation acquired in the same transaction. If an S corporation makes QSub elections under section 1361(b)(3) for a tiered group of subsidiaries effective on the same day, see § 1.1361-4(b)(2).

(c) *Taxable income limitation.* For purposes of paragraph (a) of this section, an S corporation's taxable income limitation under § 1.1374-2(a)(2) for any taxable year is allocated between or among each of the S corporation's separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each of those determinations to the sum of all of those determinations.

(d) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. Separate determination of tax. (i) X is a C corporation that elected to become an S corporation effective January 1, 1986 (before section 1374 was amended in the Tax Reform Act of 1986). X has a net operating loss carryforward of \$20,000 arising in 1985 when X was a C corporation. On January 1, 1996, Y (an unrelated C corporation) merges into X in a transaction to which section 368(a)(1)(A) applies. Y has no loss carryforwards, credits, or credit carryforwards. The assets X acquired from Y are subject to tax under section 1374 and have a net unrealized built-in gain of \$150,000.

(ii) In 1996, X has a pre-limitation amount of \$50,000 on dispositions of assets acquired from Y and a taxable income limitation of \$100,000 (because only one group of assets is subject to section 1374, there is no allocation of the taxable income limitation). As a result, X has a net recognized built-in gain on those assets of \$50,000. X's \$20,000 net operating loss carryforward may not be used as a deduction against its \$50,000 net recognized built-in gain on the assets X acquired from Y. Therefore, X has a section 1374 tax of \$17,500 ($\$50,000 \times .35 = \$17,500$, assuming a 35 percent tax rate) for its 1996 taxable year.

Example 2. Allocation of taxable income limitation. (i) Y is a C corporation that elects to become an S corporation effective January 1, 1996. The assets Y holds when it becomes an S corporation have a net unrealized built-in gain of \$5,000. Y has no loss carryforwards, credits, or credit carryforwards. On January 1, 1997, Z (an unrelated C corporation) merges into Y in a transaction to which section 368(a)(1)(A) applies. Z has no loss carryforwards, credits, or credit carryforwards. The assets Y acquired from Z are subject to tax under section 1374 and have a net unrealized built-in gain of \$80,000.

(ii) In 1997, Y has a pre-limitation amount on the assets it held when it became an S corporation of \$15,000, a pre-limitation amount on the assets Y acquired from Z of \$15,000, and a taxable income limitation of \$10,000. However, because the assets Y held on becoming an S corporation have a net unrealized built-in gain of \$5,000, its net recognized built-in gain on those assets is limited to \$5,000 before taking into account the taxable income limitation. Y's taxable income limitation of \$10,000 is allocated between the assets Y held on becoming an S corporation and the assets Y acquired from Z for purposes of determining the net recognized built-in gain from each pool of assets. Thus, Y's net recognized built-in gain on the assets Y held on becoming an S corporation is \$2,500